

Q2 07

EastBay



ECONOMIC OUTLOOK



**Created for the
East Bay Economic Development Alliance
&
The Contra Costa Council**

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The U.S. Forecast: A Long Runway for the Soft Landing

David Shulman, Sr. Economist, UCLA Anderson Forecast

Although we continue to believe that our no recession/soft landing thesis for the national economy remains intact, we are becoming increasingly nervous about the economic outlook as the period of below trend growth grinds on. Put bluntly, the credit crunch in the subprime mortgage market will likely trigger a second leg down in the housing market in terms of output and prices. Where previously we were forecasting housing starts for 2007 to come in at 1.48 million units, we now believe a level of 1.33 million units is more appropriate.

Moreover while the recent squall in the financial markets will have the salutary effect of lowering government bond yields and hastening an easing of monetary policy, it will be partially offset by the long-awaited increase in the risk premiums on corporate debt, which could negatively impact corporate investment. Nevertheless, with consumption holding up better than we had previously thought, the trade picture getting less negative and at least two 25 basis points rate cuts expected from the Fed, real GDP growth should remain positive for the balance of the year.

In many respects the economy is a mirror image of 2000. Then the corporate sector was over extended in the aftermath of the dotcom and telecom booms while consumer and housing credit were in pretty good shape. Today, it is housing credit that is in deep trouble, while the corporate sector is awash with cash and operating cash flow. It is thus troubling to see weakness in the recent data for corporate investment. But after being down modestly in the fourth quarter and essentially flat in the current quarter, we forecast investment in producers' durable equipment to rebound to around a 7% annual rate in the second quarter thereby cushioning the housing downturn. The one real bright spot remains commercial construction which is increasing at high single-digit annual rates.

Specifically we are forecasting real GDP growth to be 2.1%, 1.7% and 2.5%, in the first, second, and third quarters respectively. This will mark a six quarter period of positive but below trend growth. We expect the economy to return to around trend growth in the fourth quarter and for sequential GDP growth to average 3.25% in 2008. In the meantime the unemployment rate is expected to rise from February's 4.5% to 5% by the third quarter and then gradually decline. Perhaps more important to the Fed, both headline and core CPI increases are anticipated to be on a downward trajectory. By year end both core and headline CPI are expected to be increasing at around a 2% annual rate, soothing the Fed's worries about a persistent increase in inflation and heading off any more discussion of further rate hikes.

The California Forecast: A Different Strain of March Madness

Ryan Ratcliff, Economist, UCLA Anderson Forecast

At the end of 2006, the California economy looked like it was stalling: real estate-related employment was experiencing significant job losses and job growth in the rest of the economy was slowing. In the first week of March, the EDD released revised job figures for California that show that the state is weathering the real estate slump better than we first thought. Real estate employment was slightly more robust, and the slowdown on the service side of the economy was largely a statistical mirage. Unfortunately, this dose of good news was followed by the implosion of the subprime mortgage market. Looking around California, we find that the biggest surges in mortgage defaults occurred in markets where new homes are a large share of total sales – a combination of overextended first time buyers, weak prices, and builders and their lending partners offering overly aggressive financing in order to close deals. Since the subprime market was the last means of bridging the gap between stratospheric home prices and terrestrial incomes, the drying up of subprime credit suggests that home sales in California could be stagnant for some time to come.

Does the observed increase in defaults imply that we are likely to see a tidal wave of foreclosure sales in 2007? The historical record suggests that the presence of highly motivated bank sellers could generate substantial downward pressure on prices, especially if foreclosure sales become a significant share of total sales volumes. The past 30 years in California have seen two surges in mortgage defaults, corresponding to recessions in the early 1980s and 1990s. In the 1980s, there was a major increase in delinquency rates and a much smaller decrease in foreclosure rates. While economic distress caused late payments, many households were able to avoid foreclosure. In the 1990s, both delinquencies and foreclosures surged. The difference is of course the

severity of the local recessions: the 1980s recession in California was mild compared to the deep slump of the 1990s. This time around is historically unprecedented. We've seen both defaults and foreclosures explode even as the rest of the economy has been relatively healthy. The markets that have seen the biggest increase in foreclosure rates have been the markets where prices were already weak last year, but oddly enough the median sales prices in these markets look to be stabilizing even as foreclosure sales skyrocket. These mixed signals lead to awkward questions: is a no-recession surge in foreclosures irrelevant, or is it simply that the impact of foreclosures on prices is taking longer to show up than in previous cycles? Unfortunately, it's too early to tell.

Despite the uncertainty surrounding the impact of mortgage defaults, our overall forecast for California remains essentially the same. As real estate related sectors continue to be a source of job loss, we expect to see job growth in California slow to below 1% through the middle of 2008, with growth in real personal income and real taxable sales slowing to just over 2% through this period. If the Professional and Business Services sector can sustain its momentum longer into 2007, we might see a milder slowdown. However, if the carnage in subprime markets is more severe than we expect, job losses in Southern California could make things a bit worse. But the essential logic of the no recession forecast remains. While there's some wiggle room on how weak real estate will be and how much other sectors will offset this weakness, there still is no other sector that looks poised to combine with real estate to generate enough job loss to cause a recession.

East Bay Economic Update: 2007Q1

Ryan Ratcliff, UCLA Anderson Forecast

April 2007

Summary

The broader economic effects of the local slowdown in residential real estate continue to be the main story in the East Bay economy in the first quarter of 2007. New estimates of job creation in the East Bay published in March suggest that the East Bay was growing slower than previously thought, thanks almost entirely to sluggishness in Construction and real estate related Financial Activities. However, strength in health care and professional business services was able to offset some of this weakness, leading to overall job growth that was on par with the rest of California.

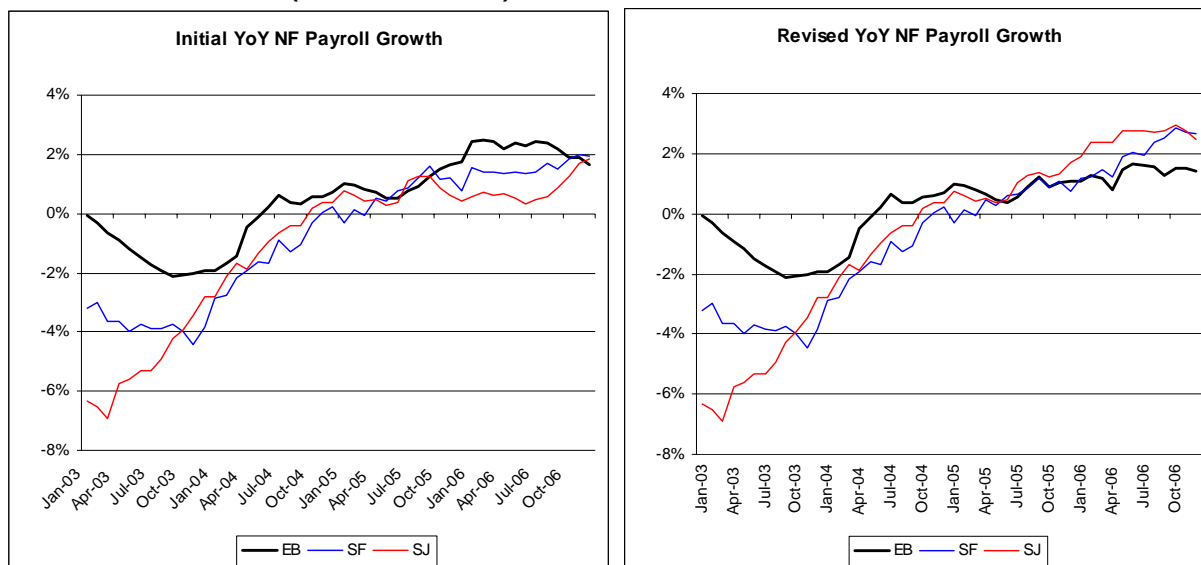
Recent news out of the local housing markets was decidedly mixed. Home prices appear to be stabilizing in the East Bay: Contra Costa County has reversed some of its recent losses, and Alameda County has actually hit new highs. Similarly, there are some signs that sales volumes in both counties may be leveling off. Unfortunately, these encouraging signs have largely been overshadowed by the surge in mortgage defaults over the past six months. Thanks to a combination of overstretched first-time buyers, weak prices, and aggressive lending by builders and their lending partners, the East Bay has seen a bigger percentage increase in defaults than anywhere else in California except the Sacramento area.

Looking forward, real estate will continue to be a drag on local growth for the rest of 2007, but will not be enough to tip the wider economy into recession. The collapse of the subprime lending market will keep home sales weak for some time to come. We expect foreclosure activity to remain high, keeping home prices flat to slightly falling through at least the end of the year.

Mixed News from the March Employment Revisions

While the March employment revisions were good news for California, they were mostly bad news for the East Bay. Total non-farm payroll job creation in 2006 was revised from 17,600 (+1.67%) down to 14,900 (+1.42%). These revisions substantially change the regional picture of the Bay Area economy. While the initial estimates showed employment in the East Bay growing significantly faster than the rest of the Bay Area in 2006, the combination of downward revisions in the East Bay and upward revisions in the San Francisco and San Jose metros now show that the East Bay largely missed out on the Bay Area's job growth acceleration in 2006.

Bay Area Year-over-Year Growth in Non-Farm Payroll Employment, Initial Estimates (3/05 Benchmark) vs. Revised Estimates (3/06 Benchmark)



Source: CA EDD, UCLA Anderson Forecast

The main source of the recent boom in job creation in the San Francisco and San Jose metros has been a combination of the Information and Professional/Technical Services sectors, as the service side of Silicon Valley finally gets back on its feet. While Professional/Technical Services has been one of the biggest sources of new jobs in the East Bay as well, the number of new East Bay jobs created in this sector in 2006 was only half that of the San Francisco and San Jose regions.

However, neither the San Francisco nor San Jose metro area is anywhere near the previous levels of employment in Professional/Technical Services that they had attained before the recession, while the East Bay has more employment than ever in this sector. Thus, this growth differential in high-tech employment is really just reflects a recovery. The rapid growth in high-tech employment in Silicon Valley and the Peninsula is the boom after a huge bust, while the job growth in the East Bay is the slower but steady job growth of a sector at peak strength.

While the high-tech economy explains the differences in employment growth within the Bay Area, it's not the main story for the East Bay economy. Like the rest of California, the main source of the recent sluggishness has been real estate.

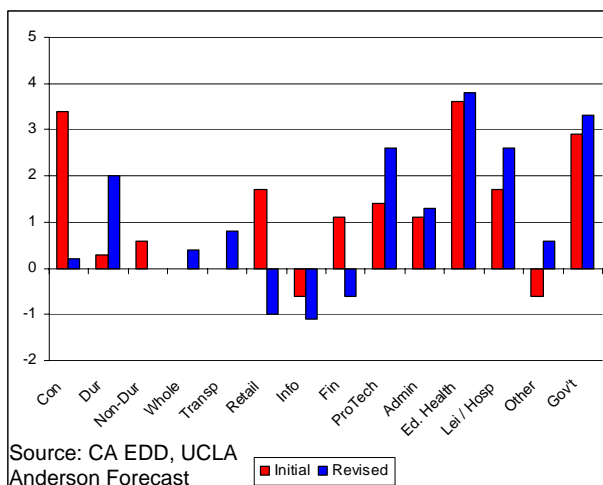
For several quarters, we had been perplexed by the local Construction industry, which continued to post record job gains even as Construction growth was slowing in every other part of the state. As it turns out, this strength was largely a statistical mirage: the new revisions suggest that the Construction sector in the East Bay was essentially treading water through 2006. Like the rest of California, mortgage-related job loss was worse than the initial estimates, turning the Financial Activities sector from a source of growth to a source of job loss in 2006. Retail Trade also swung from a net gainer to a net loser in 2006. Most of this revision came as the result of merger-driven job loss at department stores, though just about every retail category experienced some job loss in 2006. Job losses in the Information sector were revised slightly higher as the slow bleed of jobs from the Telecommunications and non-internet Publishing jobs continued.

However, it wasn't all bad news: the East Bay did have several employment categories revised up. Like the rest of California, estimates of job creation in the high-wage Professional and Technical Services category were nearly doubled. Unfortunately, all we know about the specific industries is that these gains occurred outside the computer-related consulting sector. Unlike the rest of California, the revisions also show that the East Bay is one of the only regions to experience substantial job growth in Durable Goods Manufacturing, adding nearly 2000 new jobs in 2006. However, this growth was not in the Computer and Electronics Product Manufacturing category, which makes up the bulk of Durable Manufacturing employment in the East Bay. The older but more detailed data in the Quarterly Census of Employment and Wages suggests that these jobs gains are concentrated instead in metal-related industries. From 2005Q1 to 2006Q2, Alameda County's biggest increase in Durable Goods Manufacturing employment was the addition of 295 new jobs in Primary Metal Manufacturing, while Contra Costa County added 921 new jobs in Fabricated Metal Manufacturing over the same period. Computer-related manufacturing employment in the East Bay has been essentially flat since 2004, mirroring a larger trend throughout the state.

The Health Care Sector: Business Cycle Insurance for the East Bay?

The downward revision in Construction employment leaves Education and Health Care as the uncontested leader in East Bay job growth in 2006 – continuing this sector's track record of buffering the impact of economic shocks in the East Bay economy. This cushioning comes from two sources: the Health Care sector offers above average wages, and has a favorable combination of high average employment growth and low employment volatility – it doesn't boom, but it doesn't bust.

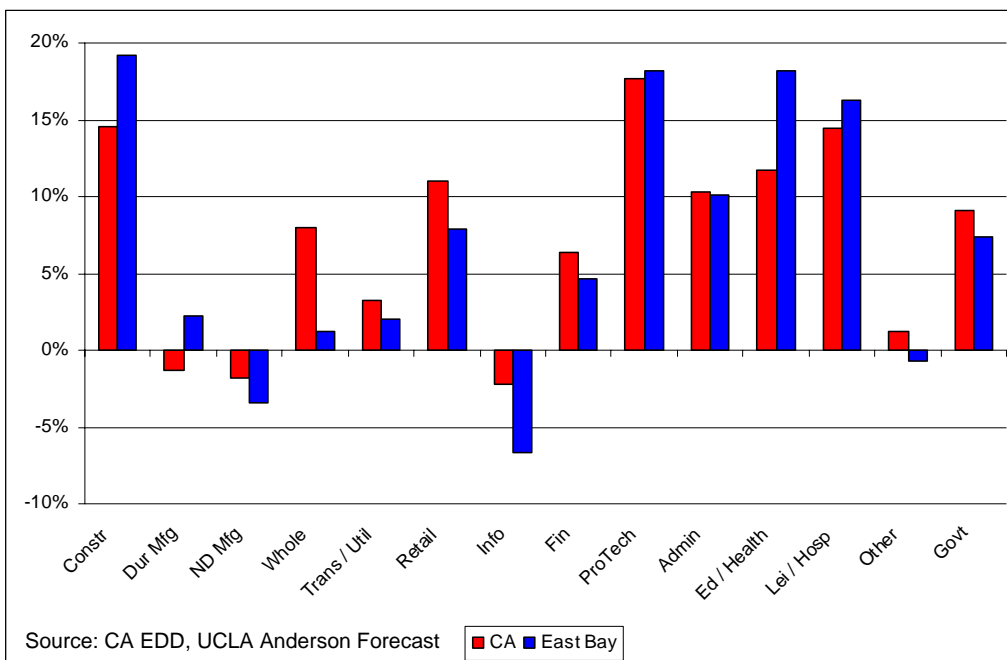
**New East Bay Jobs by Major Sector (1,000s):
Initial Estimates (3/05 Benchmark) vs.
Revised Estimates (3/06 Benchmark)**



This sector accounts for an above average share of the East Bay economy: according to the most recent data from 2005, 8.4% of Alameda County's and 10% of Contra Costa County's total employee compensation came from the Health Care and Social Assistance sector, compared to the state average of 7.7%. Similarly, the Education and Health Care supersector has accounted for 16% of new job growth from January 2004 to January 2007, compared to 12% for the state as a whole. The East Bay's specialization in Health Care is projected to expand in the next five years. The EDD's occupational projections from 2002-2012 have Health Care Practitioners and Health Care Support Occupations as the two fastest growing occupational classes in the East Bay, driven by growth in everything from doctors and nurses to lab technicians and live-in caregivers.

Share of Total East Bay Job Growth by Sector, Jan. 2004 to Jan. 2007

Around the state, the jobs outlook in the next couple of years hinges on the ability of other sectors to offset the drag from real estate related employment as the housing slump deepens. This is a classic good news / bad news story for the East Bay. The bad news is that the East Bay's above average reliance on job growth in Construction since 2004 means that the local economy will feel the impact

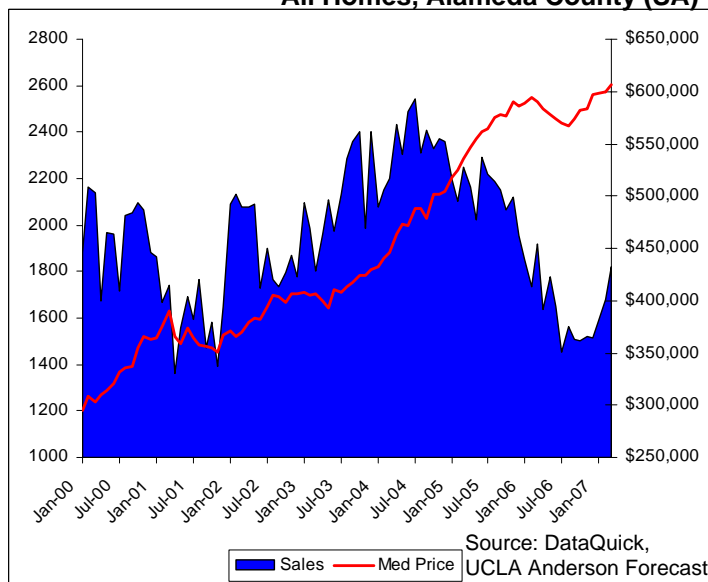


of slower building more than other parts of the state. But the good news is that the region's specialization in Health Care employment means that non-real estate related employment in the East Bay should prove less volatile than other areas California. While it looks unlikely that Health Care employment growth will accelerate much in the next two years, this sector should continue to provide a welcome source of steady growth in high wage jobs.

Residential Real Estate: Markets Stabilize as Defaults Surge

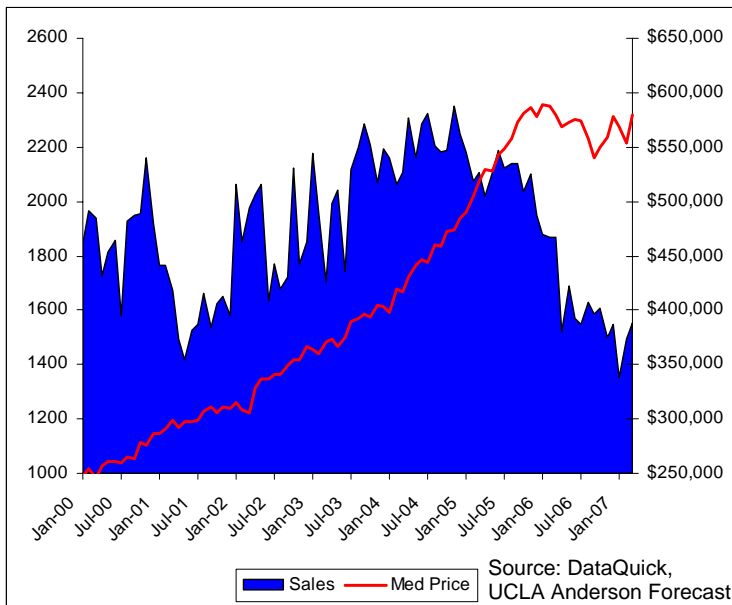
For most of 2006, the East Bay joined San Diego and the Sacramento area on the list of major home markets in California that experienced the biggest declines in home prices, thanks largely to the weakness of the prices of the large number of new homes in these markets. After reaching a high of \$594,000 in February 2006, by July the seasonally-adjusted median sales price of all homes in Alameda County had fallen 4.5%. Contra Costa experienced an even larger decline, dropping by just over 8% from February to September 2006. However, the most recent data for the region suggests that unlike these other weak markets, home prices in the East Bay may actually be stabilizing. Contra Costa County has recovered some of these losses in

Total Sales and Median Sales Price of All Homes, Alameda County (SA)



recent months, and the seasonally-adjusted median sales price in Alameda County actually surpassed its previous highs in December. Similarly, while sales volumes in both counties are still falling, the speed of the volume declines in both markets looks to be slowing.

Total Sales and Median Sales Price of All Homes, Contra Costa County (SA)

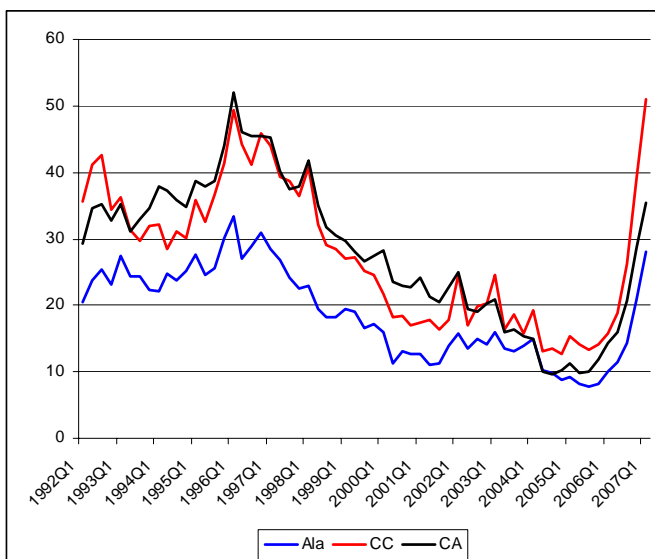


That's the good news. At the same time, mortgage defaults in the East Bay have surged to levels not seen since the 1990s. From the fourth quarter of 2005 to the fourth quarter of 2006, the number of notices of default filed increased 150% in Alameda County and 179% in Contra Costa. The rate of defaults per 10,000 households is below the California average in Alameda County, but Contra Costa County's rate is among the highest in the state: above the default rates seen in San Diego, but less than those seen in the San Bernardino, Riverside, and the Sacramento areas. Foreclosure activity has seen a similar spike, with Contra Costa bearing the brunt in the East Bay.

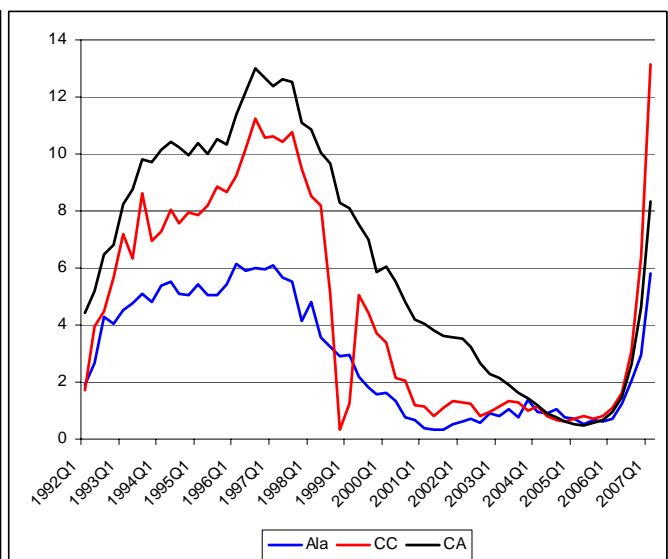
Interestingly, the list of counties with the biggest increases in defaults contains the usual suspects: Sacramento, San Diego, the Inland Empire, and the East Bay. So why would counties where new homes are a higher share of overall sales be experiencing more defaults?

There are several possible explanations. First, the geography of these counties suggests an above average presence of first time home buyers moving to more affordable areas, and first time buyers without a major equity windfall from their last home are the most likely to stretch to afford their first mortgage. Second, as prices in

Notice of Mortgage Defaults Filed per 10,000, All Households



Foreclosure Sales per 10,000 All Households



Source: DataQuick, CA Dept. of Finance, UCLA Anderson Forecast

these more affordable markets exploded in the latter part of the boom, more builders entered these markets with an interest in moving inventory quickly – including stretching lending standards to close a deal. Last, when these markets softened and builders began to cut prices in order to avoid building up inventory, weak home

prices in these areas limited the ability of new home buyers to refinance, which closed off one way of escaping an overbearing mortgage.

Increase in Notice of Defaults by County vs. Share of New Homes Sales / Total Sales



Source: Dataquick, UCLA Anderson Forecast

One of the most puzzling aspects of this spike in defaults and foreclosures is that it so far has had little effect on the East Bay housing market. Overall median sales prices have stabilized at exactly the same time that foreclosure sales have surged. One of the main lessons of the 1990s housing market in California was that an increase of discounted foreclosure sales will lead to a weakness in overall home prices. Does our recent experience contradict this lesson, or is it simply that the impact of these foreclosures is just around the corner. Unfortunately, it's too early to tell. We should have a better sense for the impact of foreclosures on home prices later this summer. The data on subprime originations suggests that the impact of most of the recent difficulties will show up this summer

Gross Domestic Product & Cost of Living	GDP - Annual Rate of Increase (National)			CPI (San Francisco)			CPI (US All Cities)		
	Q4 06	Q1 07	Change	Dec-06	Feb-07	% Change	Dec-06	Feb-07	% Change
	2.5%	1.3%	-1.20%	210.4	213.688	1.56%	201.8	203.499	0.84%
Source: BEA, BLS									
Labor	East Bay			San Jose			San Francisco		
	Dec-06	Mar-07	% Change	Dec-06	Mar-07	% Change	Dec-06	Mar-07	% Change
Labor Force	1,280,600	1,281,800	0.1%	869,600	873,900	0.5%	937,600	939,600	0.2%
Employed Residents	1,230,400	1,227,000	-0.3%	834,200	835,700	0.2%	905,300	904,400	-0.1%
Unemployment	3.9%	4.3%	0.4%	4.1%	4.4%	0.3%	3.4%	3.7%	0.3%
Payroll Employment	1,065,600	1,054,900	-1.0%	913,400	909,900	-0.4%	985,700	978,500	-0.7%
Goods Producing	173,200	169,700	-2.0%	218,900	217,900	-0.5%	87,800	86,100	-1.9%
Service Providing	707,400	696,800	-1.5%	530,500	526,800	-0.7%	761,900	755,100	-0.9%
Government	183,800	187,100	1.8%	97,500	97,700	0.2%	132,900	134,300	1.1%
Source: California EDD									
Non-Residential Vacancies	East Bay			San Jose/Silicon Valley			San Francisco		
	Sep-07	Dec-06	Change	Sep-06	Dec-06	Change	Sep-06	Dec-06	Change
Industrial	7.0%	8.2%	1.2%	10.0%	9.7%	-0.3%	5.5%	5.7%	0.2%
Downtown Office	11.1%	11.6%	0.5%	20.9%	20.0%	-0.9%	11.9%	11.6%	-0.3%
Suburban Office	15.1%	15.4%	0.3%	8.0%	6.9%	-1.1%	17.8%	15.8%	-2.0%
Source: Colliers International									
Construction Permits (by MSA)	East Bay			San Jose			San Francisco		
	12/05-3/06	12/05-3/06	% Change	12/05-3/06	12/05-3/06	% Change	12/05-3/06	12/05-3/06	% Change
Housing Permits (Number)	3,413	3,035	-11.1%	1,774	1,282	-27.7%	1,858	821	-55.8%
Non Residential Permits (Thousands of \$)	\$412,538,978	\$388,650,469	-5.8%	\$456,609,272	\$639,404,340	40.0%	\$517,488,534	\$469,354,462	-9.3%
Source: Construction Research Industry Board									
Tourism & Travel	East Bay			San Jose			San Francisco		
	Feb-07	Feb-06	% Change	Feb-07	Feb-06	% Change	Feb-07	Feb-06	% Change
Hotel Occupancy	64.5%	63.3%	2.0%	72.1%	73.0%	-1.3%	72.4%	65.9%	9.8%
Hotel Room Rates	115.99	109.57	5.9%	135.38	123.87	9.3%	167.57	157.58	6.3%
	Mar-07	Mar-06	% Change	Mar-07	Mar-06	% Change	Jan-07	Jan-06	% Change
Airline Traffic	1,188,511	1,182,653	-0.50%	884,826	904,298	-2.20%	2,527,036	2,471,702	2.20%
Source: PFK Consulting, OAK, SJC, SFO Airports									
Home Prices/Sales	Alameda	Contra Costa	Napa	Santa Clara	Solano	San Mateo	San Francisco	Marin	Sonoma
Median Price March 2007	\$598,000	\$575,000	\$590,000	\$755,000	\$445,000	\$753,000	\$682,500	\$825,000	\$520,000
Annual % Change	3.1%	0.6%	-9.2%	0.7%	-3.3%	-2.1%	1.6%	-0.1%	-5.5%
Number Sold March 2007	1,840	1,443	124	796	527	640	2,052	289	606
Annual % Change	-10.5%	-31.2%	-18.4%	-1.8%	-36.4%	1.4%	-22.0%	-24.7%	-19.2%
Source: Data Quick									
Foreign Trade	San Francisco Trade District			The East Bay Quarterly Indicators supplements the Monthly Economic Update is a compilation of local and national indicators compiled by the East Bay EDA from a number of sources. If you have any questions or suggestions regarding these indicators and/or their sources, please contact Stephanie Brown, Economic Development Analyst, (510) 272-6843 or visit www.eastbayeda.org					
	Feb-06	Feb-07	% Change						
Imports	3,051,724	3,366,450	10.3%						
Exports	4,952,535	4,942,651	-0.2%						
Source: Rand California									